

# **OFFSHORE CONTRACTS**

## **LIABILITY AND INDEMNITY REGIMES**



Candidate number: 2018

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Deadline for submission: September 01/2008

Number of words: 17,460 (max. 18.000)

05.09.2008

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# Content

<b><u>CHAPTER 1</u></b>	<b><u>INTRODUCTION</u></b>	<b><u>1</u></b>
<b><u>CHAPTER 2</u></b>	<b><u>OVERVIEW OF THE REGULATORY FRAMEWORKS</u></b>	<b><u>4</u></b>
2.1	United Kingdom's licensing system	4
2.2	Norwegian Oil and Gas Industry	8
2.3	Oil and Gas Industry in Brazil	10
2.4	Defining a contracting strategy	12
<b><u>CHAPTER 3</u></b>	<b><u>STANDARD CONTRACTS</u></b>	<b><u>16</u></b>
3.1	Why standardizing agreements	16
3.2	Standard contracts – Norway, UK and Brazil	17
<b><u>CHAPTER 4</u></b>	<b><u>ALLOCATION OF RISKS</u></b>	<b><u>19</u></b>
4.1	The knock-for-knock principle	19
4.1.1	Loss and damages	20
4.1.2	Third Party claims	26
4.2	Industry mutual hold harmless	28
4.3	The exclusion of gross negligence and willful misconduct.	31
4.4	Drafting Effective Indemnities Provisions	32
4.4.1	Basic structure of an indemnity provision	32
4.4.2	Overall cap	36

<b>4.5</b>	<b>Liabilities and indemnities provisions in standards agreements</b>	<b>37</b>
4.5.1	LOGIC - Standard Contract - Construction - Edition 2 (UK) – Liabilities and Indemnities Clause	
	38	
4.5.2	NF 07– Liability clause	43
4.5.3	PNBV Contract – Liability clause	50
<b><u>CHAPTER 5</u></b>	<b><u>CONCLUSION</u></b>	<b><u>56</u></b>
<b><u>ABBREVIATIONS AND DEFINITIONS</u></b>		<b><u>59</u></b>
<b><u>LIST OF SOURCES</u></b>		<b><u>60</u></b>
<b><u>LIST OF ANNEXES</u></b>		<b><u>A</u></b>
	Annex I - Logic contract	<b>B</b>
	Annex II - NF/07	<b>C</b>
	Annex III - PNBV Contract	<b>D</b>
	Annex IV - IMHH Deed	<b>E</b>

## **CHAPTER 1 INTRODUCTION**

The development phase of an offshore oil field involves a series of contracting activities which are no less complex than the projects themselves. Along the years, this has led to an area of expertise for the legal community in the oil and gas industry worldwide.

A good illustration of this is the evolution over the years of the oil companies' procurement strategy for procurement of offshore installations.

With ever-improving technologies available subsurface, subsea and on the processing facilities themselves, the complexity and magnitude of these projects for procurement of offshore installations have increased dramatically. In order to cater for this increased complexity and magnitude (involving several contractors, subcontractors, suppliers, sub-suppliers etc) the industry has developed the so-called EPC (Engineering, procurement and construction) and EPIC (Engineering, procurement, installation and commissioning) types of contracts.

The main objective of those forms of contracts was to simplify the contracting process, creating a single point of responsibility and to reduce as much as possible the interfaces and management between engineering, procurement and construction activities. A secondary objective, but no less important, was a will to reduce the overall delay between oil discovery and start of production, thus increasing the economic profitability of those massive offshore projects.

In order to achieve the above and to avoid time-consuming negotiations, significant work and efforts were invested so as to define a fair balance between contracting parties by designing standard agreements. This was first done by the oil industry in Norway with

edition of The Norwegian Fabrication Form<sup>1</sup>, followed-up in the United Kingdom – The standard contracts for UK offshore oil and gas Industry<sup>2</sup>, both of which will be detailed further in this dissertation and the creation of the industry mutual hold harmless scheme in the United Kingdom continental shelf.

Central to this dissertation will be the liabilities and indemnities regimes adopted in those standard agreements, particularly the allocation of risks for (i) loss and damages to property owned by each contracting parties, (ii) personal injuries, death or illness of personnel, (iii) indirect or consequential losses and (iv) third party claims arising out of personnel injuries, illness or death, or property loss or damages suffered by third parties. The knock-for-knock principle and mutual hold harmless scheme will be introduced as these are the central legal pieces of the contracts supporting offshore installations projects.

As will be addressed in this dissertation, the knock-for-knock principle and mutual hold harmless scheme have created by virtue of agreements a special liability regime which differs from what would normally be provided by each respective legal systems and statutes.

This dissertation will also describe the liability regimes adopted in Brazil by the state-owned oil company Petroleo Brasileiro SA – Petrobras in the so called “PNBV Contract”. Firstly, because as a counter-example to the regimes developed in the North Sea<sup>3</sup>, it illustrates perfectly the main principles. Secondly, recent new oil field discoveries (2007) on the Brazilian continental shelf are extremely promising for the oil and gas industry, with expectations to require a significant portion of all world-wide new (or refurbished) offshore installations for the next 10-20 years.

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<sup>1</sup> The Norwegian Fabrication Form was originally edited in 1992 and subsequently reviewed. Last edition published in 2007.

<sup>2</sup> Formerly Crine Standard Contracts. See further in chapter 3.2.

<sup>3</sup> The North Sea connects with the rest of the Atlantic through the Dover Strait and the English Channel in the south and through the Norwegian Sea in the north.

It will also be reviewed the position at English law in respect to the effectiveness of liabilities and indemnities provisions, in particular, the cases derived from the Piper Alpha<sup>4</sup> disaster, which have opened high level discussions on the enforcement of such provisions. Based on those English law cases it will be present some considerations of how to draft effective liabilities and indemnities provisions.

The main focus of this dissertation is to identify the differences between liability regimes used in Norway, UK and Brazil. This in turn will be of assistance for Contractors to correctly identify the level of liability they may be exposed to when performing services in these three countries.

The issue concerned with applicable local laws will not be central for this dissertation as most of those contracts (except the NF07 one) do provide the English Law as the governing law to solve any disputes that may result from the contract execution. However, the experience of the English courts will be discussed as a general guideline of how to draft effective liabilities and indemnities provisions.

Finally, it is relevant to remark that when responsibilities and liabilities are split between contracting parties, the insurance regime also needs to be taken into consideration. It was out with the realm of this dissertation to address in depth the insurance schemes and the associated risk allocations linked to such schemes. It is however suggested that this dissertation and its structure can be used as a basis and reference point for such analysis. Therefore, this dissertation will focus on the legal contractual aspects only.

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<sup>4</sup> See further herein chapter 4.1.1

## CHAPTER 2 OVERVIEW OF THE REGULATORY FRAMEWORKS

Prior to entering into the main subject of this dissertation, this chapter will give an overview of the regulatory frameworks for the oil and gas industry in UK, Norway and Brazil.

### 2.1 United Kingdom's licensing system

The oil and gas industry in the UK is based on a licensing system controlled and administered by its Department for Business, Enterprise and Regulatory Reform (the "BERR").

The Petroleum Act 1998, which is the master regulation in the UK oil and gas sector, vests in the Crown the exclusive rights to search for, bore for and get petroleum in the United Kingdom Continental Shelf<sup>5</sup>. However, the Secretary of State for the Department Business, Enterprise and Regulatory Reform (BERR)<sup>6</sup>, hence the Government has the power to grant licences that confer exclusive rights to "search and bore for and get" petroleum to a private party<sup>7</sup>.

The UK Continental Shelf (UKCS) comprises those areas of the sea bed and subsoil beyond the territorial sea over which the UK exercises sovereign rights of exploration and exploitation of natural resources. The exact limits of the UKCS are set out in orders made

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<sup>5</sup> See further. Petroleum Act 1998. 2. Rights to petroleum vested in Her Majesty (2).

<sup>6</sup> The Energy Department Unit (part of BERR's Energy Command) is responsible for licensing exploration and regulation development of UK's oil and gas resources.

<sup>7</sup> See Further. Petroleum Act 1998. 3 Licences to search and bore for and get petroleum (1).

under section 1(7) of the Continental Shelf Act 1964. In addition, agreements to divide the continental shelf according to the median line principles<sup>8</sup> were concluded between Norway and UK in March 1965<sup>9</sup>.

The process to grant these licences involves close examination of the technical and financial capacity of these private parties by the BERR. The applicants for a licence (private party) shall first submit a proposal to the BERR, which will be reviewed and selected in a licence round process. The rights granted by those licences will be limited to a specific area and for a limited number of years.

Licences are very similar to contracts in their format, but they also contain many regulatory elements. The rights and obligations regulating the relationship between Government and a private party (licensee) are described in the licence and are also set forth in the Model Clauses. The Petroleum Act requires that such regulatory conditions – Model Clauses<sup>10</sup> – be first published in a secondary legislation.

In summary the seaward licensing system consists of 2 main types of licences: (i) Production Licences and (ii) Exploration Licences. Production Licences are the main type of seaward licence and despite their name they cover the entire life of an oil field from exploration to decommissioning. In an effort to promote new entrants in the UK sector, and making the UKCS an attractive business to smaller oil companies, the Government has introduced 3 variations of the Traditional Production Licence, such as Promote Licences, Frontier Licences and Licences specially drafted to cover the redevelopment of a decommissioned field. One of the main attractive differences between these new licences and the traditional licences is that the new ones provide more flexibility in terms of

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<sup>8</sup> The median line is the line every point of which is equidistant from the nearest points on the baselines from which the breadth of the territorial seas of the neighboring states measured.

<sup>9</sup> Petroleum law compendium / Nordisk institutt for sjørett. - Oslo: Instituttet, 2003. – Book 1. pag. 9

<sup>10</sup> The model clauses currently in use for Seaward Production Licences can be inspected on the OPSI (Office of Public Sector Information) website at the [Petroleum Licensing \(Production\) \(Seaward Areas\) Regulations 2008 \(2008/225\)](#). Those used for Landward Production Licences and for Seaward Exploration Licences are at the Petroleum Licensing (Exploration and Production) (Seaward and Landward Areas) Regulations 2004 (No 352)



minimum work obligation the licensees have to commit to in the initial term of the licence (i.e. exploration).

The second main type of licence is the Exploration Licence. It is suitable for companies performing exploratory surveys over wide areas of the offshore sector. The rights granted by the Exploration Licence are neither exclusive nor limited to a specific area. It can thus cover any location within the UKCS, as well as allow exploration within an area already covered by an existing Production Licence. However, in this last case, an agreement with the holder of the particular Petroleum Licence will be required.

According to the information displayed on the BERR website<sup>11</sup>: *The UK's licensing system covers oil and gas within Great Britain, its territorial sea and on the UK Continental Shelf (UKCS). Northern Ireland's offshore waters are subject to the same licensing system as the rest of the United Kingdom Continental Shelf. Northern Ireland issues its own Licences to cover its onshore area, independently of BERR. The Isle of Man issues Licences for its own onshore area and territorial waters.*

*The designated area of the UKCS has been refined over the years by a series of designations under the Continental Shelf Act 1964 following the conclusion of boundary agreements with neighboring states. The most recent is the Scottish Adjacent Waters Boundaries Order 1999 (No. 1126) implementing an agreement reached with the Faeroe Islands.*

The development and production phases of oil and gas fields in the UK are also subject to a licensing regime and special regulations<sup>12</sup> overseen by the BERR. A licensee wishing to develop a new field is required to apply for development consent to the BERR. This

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<sup>11</sup> See [www.org.berr.gov.br](http://www.org.berr.gov.br)

<sup>12</sup> Guidance notes on procedures for regulating offshore oil and gas field developments, issued by the BERR.

process is initiated by the submission of a Field Development Plan (FDP), together with an environmental statement<sup>13</sup> discussing the environmental impact of the proposed development.

The criteria used by the BERR when reviewing a field development program, are (i) the maximization of the UK economic benefit from its oil and gas resources, by ensuring the recovery of all economic reserves of hydrocarbons (ii) the environmental impact of hydrocarbon development and the interests of other users of the sea (iii) the need to ensure secure, diverse and sustainable supplies of energy to UK businesses and consumers at competitive prices, (iv) and finally, adequate and competitive provision of pipelines and facilities.

In addition to the regulations and required criteria for the development of an oil and gas field, when a discovery is considered as having commercial potential, the licensees will be looking for the most cost effective development and this factor will mostly drive the decision of the optimum development solution. In brief, other factors as: water depth, weather conditions, proximity to infrastructures, proximity to markets and size of discovery, will influence such decision.

As said in the introduction of this dissertation, the contracting strategy adopted by the oil company will be influenced by the factors above mentioned above.

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13 Environmental approval will also be required prior to FDP consent being given.

## 2.2 Norwegian Oil and Gas Industry

Rights to explore and to produce subsea petroleum deposits under Norwegian jurisdiction are also organized through a licensing system, however, stronger interfaces with participation of the government are observed. Some of the particularities of the Norwegian licensing system will be addressed in this chapter.

The Norwegian Jurisdiction is found in the international law and comprises Norwegian internal waters, Norwegian Sea territory, and the continental shelf<sup>14</sup>. The term continental shelf includes the seabed and subsoil of the marine areas extending beyond the Norwegian territorial sea, throughout the natural prolongation of the Norwegian land territory to the outer edge of the continental margin (but no less than 200 nautical miles from the base lines from which the breadth of the territorial sea is measured). However, not beyond the median line to another state, unless otherwise can be derived from the rules of international law for the continental shelf beyond 200 nautical miles from the base lines, or from an agreement with the relevant state<sup>15</sup>.

The main characteristic of the Norwegian oil and gas industry is the indirect regulation of the sector by the government. Government interventions are present at each phase of the main activities required for exploration and production of oil and gas resources.

The main legal text in Norway regulating the oil and gas sector in Norway is the Petroleum Act 1996<sup>16</sup> which reflects the principles of the European Economic Area Agreement<sup>17</sup>. The Norwegian licence system comprises of three types licences: (i) Exploration Licence, (ii) Production Licence and (iii) Pipeline Licence.

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<sup>14</sup> Petroleum law compendium / Nordisk institutt for sjørett. - Oslo: Instituttet, 2003. – Book 1. pag. 9

<sup>15</sup> Petroleum Act 1996, section 1-6 1.

<sup>16</sup> The Norwegian Petroleum Act was originally issued in 1985.

<sup>17</sup> The European Economic Area Agreement was signed 2 May and entered into force 1 January 1994

The Exploration Licence is granted for a limited area and a limited period. It does not confer exclusive rights, but it allows conducting of various kinds of surveys on the seabed in order to identify potential petroleum deposits. No rights to drill to obtain a further Production Licence are implied by the Exploration Licence.

The Production Licence is the core licence of the Norwegian licensing system and grants the licensee exclusive rights of exploration, drilling and production of petroleum resources within limited area and time period. However, the Production Licence does not give the licensee the rights to build and operate a pipeline for the transportation of its petroleum to the market. Such rights will require a separate licence called the Pipeline Licence.

The main purpose of a separate licence for pipeline activities is to give the owners of the pipeline an incentive to charge low transportation tariffs and to provide a self regulating mechanism.

The development phase of an oil field can only start from the approval by the State of a development plan which shall be submitted by the licensee in relation to a commercial discovery. The criteria used by the Norwegian government for the approval of a development plan will be the complete or partial removal of the installation and the continued use of the facilities for petroleum or other purposes.

The plan shall also contain an account of economic aspects, resource aspects, technical, safety related, commercial and environmental aspects, as well as information as to how a facility may be decommissioned and disposed of when the petroleum activities have ceased. The plan shall also comprise information on facilities for transportation or utilization comprised by Section 4-3 of the Petroleum Act 1996. In the event that a facility is to be placed on the territory, the plan shall in addition provide information about what

applications for required licences, which have been submitted according to other applicable legislation.<sup>18</sup>

### 2.3 Oil and Gas Industry in Brazil

The oil and gas industry in Brazil had an important period from 1995 to 1997, when the monopoly regime of the State over the activities of exploitation and production of hydrocarbon resources was changed by the introduction of a new flexible regime. The rights to explore and produce natural resources are still vested on the State<sup>19</sup>; however, the activities can be now performed (as authorized in a concession contract) by any private party<sup>20</sup>. Such change constituted an important development for the oil and gas industry in Brazil<sup>21</sup>.

During the monopoly regime the management and performance of the activities involved in the exploration and production of oil and gas were exclusively vested on the semi-public petroleum company called Petroleo Brasileiro SA – Petrobras. As a consequence of the monopoly regime ending, a Petroleum Law (Law 9478/97) was issued by the Government and a Regulatory body for the oil and gas sector was created - the National Petroleum Agency (Agencia Nacional de Petroleo - ANP)<sup>22</sup>.

The ANP was created for the purpose of (i) regulating the energy sector by issuing regulatory texts, (ii) selecting private parties and contracting with them through Concession Contracts for the exploration and production of hydrocarbons resources; (iii) supervising

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<sup>18</sup> Petroleum Act 1996, Section 4-2

<sup>19</sup> Petroleum Law (9478/97), provision No. 3.

<sup>20</sup> According to the Petroleum Law (9478/97), provision 5, such private party shall be a company incorporated under the laws of Brazil.

<sup>21</sup> Petroleum Law (9478/97), provision No.5.

<sup>22</sup> Petroleum Law (9478/97), provision No. 7, regulated by Decree No. 2.455/1998.

the regulated activities of energy sector, either directly or by agreements with the states and municipalities.

The rights to explore, develop and produce hydrocarbon resources in Brazil are granted by Concession Contracts awarded to private parties through a bid rounds process<sup>23</sup>. Applicants for a block (limited area of seabed) should first pre-qualify as participants to the round by fulfilling certain technical and financial capabilities requirements and by paying a participation fee. Once the technical and financial requirements are satisfied, the applicants have to offer a signature bonus together with a proposal to the minimum commitment for the exploration works for each of the blocks they are interested in acquiring.

The award criteria will be a combined analysis of the: (i) general work proposed by the applicant, (ii) the proposals for exploration activities, (iii) deadlines, (iv) minimum investment commitments, (v) the physical-financial chronogram (vi) and the government takes (in particular the signature bonus).

All the phases of an oil field's life, including exploration, appraisal, development, production and decommissioning are covered by the Concession Contract, although some inter-phase approvals will be required, such as the development plan approval.

Despite the energy sector opening in Brazil, Petrobras is still the main player of the sector and, as such still demands most of the development activities in the country.

As said in the introduction of this dissertation, recent oil discoveries in Brazil may represent a very promising and demanding market for development projects. According to information available at public domain, Petrobras will launch a tendering process for 28

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<sup>23</sup> Petroleum Law (9478/97), provision 23.

domestically-built deep-water rigs before the end of 2008, triggering a scramble for financing and yard slots in the country's offshore industry.<sup>24</sup>

The 28 rigs form part of a wider plan to order 40 new deep-water and ultra-deepwater units over the next nine years as Petrobras prepares for a mighty appraisal and development effort on the huge new pre-salt oil and gas discoveries<sup>25</sup> in the Santos basin<sup>26</sup>.

## 2.4 Defining a contracting strategy

For an oil company, the contracting strategy to adopt is without a doubt a key and critical parameter for the successful development of an oilfield. Before setting the overall contracting strategy, the following key parameters will normally be assessed by the oil company (or more precisely by the Operator – operating a particular oil field on behalf of the partners):

1. The Operator's standard for contracting strategy (execution model)
2. The Operator's partners guidelines (as well as the Joint Operating Agreement - JOA)
3. The project's environment (the country and legal framework where it will be operating)
4. The definition of which work packages/contracts the field will be split into
5. Timeline/schedule constraints and sequential vs. parallel project execution
6. The allocation of risk and liabilities between the Operator (the client) and the Contractor(s).

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<sup>24</sup> "We will start tendering before the end of this year for the 28 rigs that will be built in Brazil and are scheduled for delivery from 2013 onwards " Petrobras chief executive Jose Sergio Gabrielli said.

<sup>25</sup> Petrobras has made what could prove to be the largest oil discovery in 30 years, and one that would propel the already prospering country into the major league of oil exporters.

<sup>26</sup> The Santos Basin is an 352,260 km<sup>2</sup> (136,008 sq mi) offshore pre salt basin. It is located in the south Atlantic ocean, some 300 km (190 mi) south east of São Paulo, Brazil. One of the largest Brazilian sedimentary basins, it is the site of several recent (2007-2008) significant oil fields, including Tupi and Jupiter.

The series of standard agreements used in the development of an oil field will vary from Operator to Operator; however, some standards have been agreed at industry level in certain countries such as the UK and Norway and will be specifically discussed hereinafter.

The parameters described in items (2) and (3) above will not be subject to consideration in this dissertation.

When it comes to the definition of work packages (item 4 above), this is mainly driven by the maturity of the required technology, maturity of the Contractors – and by the own internal capabilities of the Operator. Although we will not explore this further in this dissertation, it should be noted that Contractors work in a competitive environment, where the tendering/bidding process is normally quite strongly regulated by laws and the oil companies own standards. Therefore the main concern of potential Contractors will be the contracting strategy adopted by the oil companies.

With respect to timeline/schedule constraints and sequential vs. parallel project execution (Item 5 above), as mentioned in the introduction of this dissertation, the schedule constraints also influence the choice of contracting strategy.

With the oil-prices we have seen lately (2007, 2008), the Operators are even more interested in getting the oil out of the ground and produce, and the share of so-called “fast-track” projects has sky-rocketed. By “fast-track” project is usually meant a project that includes some concurrent engineering and construction activities, meaning the decision is made to go ahead, as the advantages of achieving earlier oil/gas production outweighs the risk of rework (i.e. Contractors change orders).

However, we will focus here on the last item of the above-given list of parameters to be considered by the Operators when defining a contracting strategy: allocation of risk and liabilities between the Operator and the Contractor(s). As explained in the introduction, complexity and magnitude of oil and gas projects have further emphasized the need for a simplification of the contracting process, stressing the importance of determining a single



point of responsibility during the execution of the project and the allocation of risks and liabilities in a sustainable way for both Contractors and Operators.

This trend is increasingly forced upon how Operators work, because of the current demographics in the oil industry. As an illustrative fact, it can be mentioned that the oil industry had a significant downturn in 1986 world-wide, and this continued until about 2001. As a direct consequence of this, very few graduates selected to enter the oil industry during 15 years, selecting IT, telecom and other non- “brick and mortar” industries. This has created a lack of seasoned professionals (15-25 years experience) which, together with the explosive demand today, will continue until well after 2020. The direct consequence of this is that the Operators need to define contracting strategies which are not only causing the Operators themselves to use fewer personnel, but which in general also require less engineering. From a technical point-of-view, this is partially achieved by standardization, including of course: standardization of contracts and better (overall) allocation of risk and liabilities.

In the traditional contracting strategies, oil companies would perform in-house engineering - including conceptual, basic and detailed engineering - procure key components, and finally assign the execution and construction of the project to a specialized Contractor.

The EPC and/EPIC types of contracts have introduced new possibilities and new ways of proceeding by allowing Contractors to be entrusted with all phases of the project, thereby making Contractors the sole responsible entities for the delivery of a complete unit in a turn-key type of contract.

As a result, Contractors are now entrusted with greater parts of the projects, which make them not only simple employee firms working for oil companies, but rather industrial partners sharing legal responsibility for the projects, and hence exposed more and more to liability issues. This is the reason why it is so crucial to precisely identify the different types of liability regimes put into place.

Another important motivating factor for this change of contracting strategy is the increase in complexity and technology involved in those projects; some oil and gas companies do not have in-house appropriate human resources for these new areas of expertise.

Standardizing agreements also implies establishing a fair balance between rights and obligations of oil and gas companies on one hand and Contractors on the other hand; and most pre-printed ready-made agreement forms were negotiated and designed together by the main companies and Contractors of the sector.

## **CHAPTER 3 STANDARD CONTRACTS**

### **3.1 Why standardizing agreements**

Standardizing contracts is a common business practice when it comes to buying goods and services in many different industries, including the oil and gas industry where standardization is a strong element. Many examples of this can be given, at all levels of an oil or gas project: from confidentiality agreements in the preliminary stages of discussions concerning the potential interest of a field, through to agreements between oil and gas companies and their Contractors at the start of the development phase (explored in this dissertation), to the agreements regarding the production phase of an oil field.

However, unlike in most other industrial fields where agreements are standardized by an external authority, in the oil and gas industry, agreements and contracts are standardized directly by the main players in the field after negotiations between them. Therefore discussions about adhesion agreements and their legal effects will not be addressed here.

Standardized agreements are attractive to oil companies mainly because they allow for a reduction of negotiation time. By using a standard agreement, the parties can rely on a document specifically designed to follow the main agreeable principles of the oil and gas sector, and therefore likely to define an acceptable allocation of liabilities for all parties concerned.

### 3.2 Standard contracts – Norway, UK and Brazil

As mentioned in the introduction of this dissertation, the oil industry in Norway was the first to present a standard form for fabrication of offshore installations and represented an important start-up in the standardization process in the oil and gas industry. The Norwegian experience was based on the discussions between Statoil ASA (Statoil) the Norwegian state-owned company, Norsk Hydro ASA (Hydro)<sup>27</sup> and the Federation of Norwegian Industries (NI). As a result, the first draft of the Norwegian Fabrication Contract was issued in 1992, with its most recent edition published in 2007.

The United Kingdom task force for the development of standard contracts came at a later stage, but with significant new contributions. Not only by creating standard agreements, but the task force designed and implemented a global industry mutual hold harmless agreement covering all activities in the UK waters of the North Sea, which will be further explained in this dissertation. The initial works on standard agreements were handled by the CRINE (Cost Reduction Initiative for the New Era), an organization formed by senior executives from all sectors of the UK offshore industry – Operators, Contractors and suppliers - and as result the first edition of a “General Terms and Conditions for Construction” was published in June 1997. In 1999 a not-for-profit, wholly-owned subsidiary of Oil & Gas UK called LOGIC (Leading Oil and Gas Industry Competitiveness)<sup>28</sup> was created and took over most activities initially handled by CRINE. An updated version of the Standard Contract - Construction - Edition 2 was issued in October 2003 and will be subject to comments in this dissertation.

The Brazilian experience is still, at the time of writing, mostly focused on the contracts issued by Petrobras, which is the main and dominant Operator in the sector in Brazil. It

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<sup>27</sup> Statoil and Norsk Hydro's oil & gas activities were merged together to StatoilHydro later (in 2007). The merged company will as per the shareholder agreement change name in 2009 (dropping both the Statoil and the Hydro name).

<sup>28</sup> [www.logic-oil.com](http://www.logic-oil.com)

should be clarified that such model form of contract has been modified on tendering-by-tendering basis. The model which will be analyzed in this dissertation is based draft reviewed ABEMI (Brazilian association of industrial engineering)<sup>29</sup> and from where the PNBV Contract was made available for this dissertation.

The concepts of knock-for-knock and mutual hold harmless are still a challenge to be implemented in Brazil. The barriers extend from the legal system tied up in a civil code to a gape of understanding of the importance of the principles by the industry in Brazil.

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<sup>29</sup> ABEMI is profit free organization created in 1964 by a group of business man with the aim of having their engineering companies being represented towards their clients and to develop joint task force in order to add value to the sector. See further [www.abemi.org.br](http://www.abemi.org.br).

## **CHAPTER 4 ALLOCATION OF RISKS**

### **4.1 The knock-for-knock principle**

The knock-for-knock principle was primarily developed during the Second World War between insurance companies. In those most dangerous times, it was common practice for merchant and commercial vessels to travel together in groups, as convoys, for obvious safety reasons. As a result of the physical proximity of the ships, accidents between them - knocking into each other - were most likely to happen and it was always extremely difficult to determine which ship was actually responsible for the knock. Therefore, in order to avoid endless and costly judicial litigations, insurance companies decided to establish a new liability regime that did not involve a responsible entity for the accident, and hence avoided the need for recourse against other insurance companies for the same insured event. The principle was to have each insurance company pay for the damages and losses sustained by its own policy-holder, regardless of who was responsible.

The benefits of the knock-for-knock principle are multiple and extend from avoiding costly judicial litigation to the party who has suffered the losses, time consuming with the determination of who was responsible for the incident, to the avoidance of duplication of insurance policies for the same risks. However, a main point of concern in this dissertation is that the principle allows clarity of exposure to liabilities that a party to a contract will be assuming while performing such contract.

Activities in the oil and gas industry are potentially hazardous and involve high level capital investments. From a service provider's perspective, the level of exposure to losses

and damages to Operator's property, personnel or other Contractors retained by the Operator at the same worksite, and, the level of exposure to loss of production of an oil field could not only lead to an unfair balance of obligations in a contract, and sometimes, even beyond Contractor's insurance capability.

Aside from the definition of the scope of work and negotiation of the contract price, the liabilities exposure are one of the key issues of a contract elements to be negotiated and because of the exhaustive negotiations and discussions around those risks the knock-for-knock regime appeared as a reasonable and sustainable way of assessment and allocation of those risks (which can turn into billions of dollars of liabilities) that Contractors face while performing services at site for an Operator. As a consequence, the knock-for-knock principle has come to be an acceptable solution for both Contractors and Operators.

#### 4.1.1 Loss and damages

As a starting point it should be clarified that the potential exposures to liabilities that will be the subject of appreciation in this dissertation and that is covered by the knock-for-knock principle are those related to risks of: (i) loss and damages to property, (ii) personnel injuries, (iii) indirect or consequential losses. Therefore, the economic and time risk exposures resulting from default in the obligations specified in the contract such as: delay in performance, non-performance, defects, warranties to which remedies will often be provided by the general rules on breach of contract, will not be addressed in this dissertation.

As previously explained, the main purpose of the knock-for-knock principle is to reallocate potential liabilities and to establish contractual rules stating that "where the damages hit, the damages stay". In other words, each party shall support their respective losses resulting from an incident while performing a contract. In that respect, each party to a contract shall also indemnify the other from such losses and damages and waiver any rights of recourse against the other party to pursue the remedies available at law.

From a service provider's perspective, the consequence of applying this principle is to clearly delimit a fence to Contractor's exposure while performing services to or on behalf of an oil company. By assessing their risks, Contractors would be in a better position to evaluate the cost of services, to secure the risk by contracting an insurance coverage and by taking risks that be compatible with the level of their normal risk of business.

The knock-for-knock principle is reflected in the contracts by the liabilities and indemnities provisions. An indemnity is a compensation for loss or liability. It is an express obligation to compensate by making a money payment for a defined loss or liability. It is not subject to the calculation of damages under the usual legal principles for calculation of loss. The loss may be caused by the party giving the indemnity (the "indemnifier") or by another party. An indemnity is an original and independent obligation of the indemnifier to indemnify, and the indemnifier assumes primary liability for the loss or damage.

In brief, the knock-for-knock principle will apply in the form of cross-indemnities where each party to the contract will take the responsibility for, and indemnify the other party from and against, damages and losses to its own property, loss or injuries to its own personnel and its consequential losses. Another relevant aspect of such indemnities are that they are usually intended to apply irrespectively of cause, even if caused by negligence, breach of statutory duty or breach of contract of the party receiving the benefit of the indemnity (indemnified party). However, the challenge of applying the knock-for-knock principle in offshore contracts was found in the respective statutory legal regimes. The question of whether exclusion/exemption types of clause such as the indemnity clauses would be enforceable at law, and therefore, recognized by judicial courts, is a great concern of the legal community.

The experience under English Law shows that the Courts have upheld the knock-for-knock principle in contracts on the basis of the principles of freedom of contract and of a court's function to give effect to parties' agreement. However, the evolvement of court's decisions



on this matter also demonstrates that not all and any indemnity would be enforceable by the Courts, thus compromising the original intent of the parties. As a result, special attention to the wording used in these provisions becomes increasingly crucial.

One of the most important events in the North Sea, which led to several claims and as a consequence, opened high level discussions on the subject matter of the enforcement of indemnities provisions in offshore contracts, was the 1988 North Sea Piper Alpha disaster<sup>30</sup>.

Many views can be expressed as to how to draft an effective liability provision, however the lessons learned from the court's decisions in the Piper Alpha cases were of substantial contribution to the industry. Knowing the courts' views and interpretation of how those provisions would be effective is a precious guidance for the drafters.

Among a number of court proceedings occasioned by the Piper Alpha disaster, there were 2 specific cases relevant to the way of using indemnity regimes which were 1) the London Bridge case<sup>31</sup>; 2) the Orbit Valve case<sup>32</sup>.

The main importance of the London Bridge case was the recognition by the Court that mutual indemnities was a "market practice" which had developed to take into account the particular features of the offshore operations and, therefore, was acceptable.

Another important aspect of this case was the interpretation given by the Court of the indemnity provisions contained in the insurance contracts. In response to an argument raised by the Contractors (the defendants) that the Operators (the plaintiffs) would not be entitled to claim the indemnity provision given by the Contractors because the Operator had already been indemnified by their respective insurance policies, the Court decided that

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<sup>30</sup> The Piper Alpha disaster resulted in the total destruction of a gas production platform, loss of 167 lives and total insured loss was US\$3.304 billion

<sup>31</sup> Caledonia North Sea Ltd v London Bridge Engineering Ltd [2002] UKHL4; [2002] 1 Lloyd's Rep 553, HL.

<sup>32</sup> EE Caledonia Ltd v Orbit Valve Co Europe Plc [1995] 1 All ER 174 Court of Appeal

the indemnity obligations in a contract are “full and primary”. In other words, the fact that the party which suffered the loss was insured for that particular liability and received compensation in that respect, does not restrict or relieve the primary obligation provided by an indemnity provision. If one of the parties maintains insurance, despite the indemnity provision contained in the contract, it is not for the benefit of the other party, but for its own exclusive benefit. Consequently, in that case, the Operator’s insurers were entitled to be subrogated to the rights of the Operator and to be compensated from the amount paid under the insurance policy.

The Orbit Valve case was also relevant to developing the use of indemnity provisions. In this case the concept of (i) - clear drafting of the indemnity clause is required and (ii) for a “party who wishes to avoid consequences of its own negligence, clear language to this effect must be used in the relevant contract, were evolved from this decision. Based on these two concepts the drafters of indemnity provisions have come to include express wording to that effect, such as “irrespective of negligence and/or breach of duty (statutory or otherwise)”.

The court’s decision in the Orbit Valve case has confirmed the general principle of the English Law that indemnity clauses be interpreted restrictively and consequently the English courts will tend to narrowly construe the activities that are subject to indemnification. Where there is ambiguity, the indemnity clause will be interpreted in the manner least favorable to the party wishing to benefit from it. Accordingly, careful drafting is important when preparing indemnity clauses.

Therefore, in case of a clause that would give an indemnity against “any claim arising from the manner of performance of the contract” it could not be construed to exempt negligence. In summary, in the absence of clear words the parties to a contract are not to be taken to have intended that an exemption or indemnity clause should apply to the consequences of a party's negligence.

In addition to the Piper Alpha cases, it should also consider the trilogy of cases in the House of Lords<sup>33</sup> from which the classic rules of contractual interpretation have evolved from literalism to purposiveness shall also be taken. These cases are *Mannai Investment Co Ltd v Eagle Star Assurance Co. Ltd*<sup>34</sup>, *Investors Compensation Ltd v West Bromwich Building Society*<sup>35</sup> and *Bank of Credit and Commerce International SA v Ali*<sup>36</sup>. The effect of these decisions is that “Almost all the old intellectual baggage of “legal” interpretation has been discarded”<sup>37</sup>

Another equally poignant remark was made by Lord Hoffmann in *Mannai Investment Co Ltd v Eagle Star Life Assurance Co Ltd*, was the following:

*“The meaning of words, as they would appear in a dictionary, and the effect of their syntactical arrangement, as it would appear in a grammar, is part of the material which we use to understand a speaker’s utterance. But it is only a part; another part is our knowledge of the background against which the utterance was made. It is that background which enables us, not only to choose the intended meaning when a word has more than one dictionary meaning but also ... to understand a speaker’s meaning, often without ambiguity, when he has used the wrong words.”*

Another example of the above, is the English case of *West Bromwich*, the Court admitted that extrinsic evidence may be used in limited circumstances to assist the interpretation of the contract, meaning that extrinsic evidence could be used to establish the meaning of words if they clearly can not have been intended to be given their ordinary meaning.

In summary, in terms of the rules of contractual interpretation which will be of relevance for the indemnities provisions are the following:

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<sup>33</sup> Vincent, Nelson QC. Interpretation of Contracts: The Rules of Re-Written for Modern Times (handout) at pages. 3 and 4.

<sup>34</sup> [1997] 2 W.L.R. 945

<sup>35</sup> [1998] 1 W.L.R. 896

<sup>36</sup> [2002] 1 A.C. 251

<sup>37</sup> *Investors Compensation Scheme Ltd v West Bromwich Building Society op.cit.* per Lord Hoffman at p.912.

- (1) *"A clause must extend to the exact event that occurred for the party relying on it to be protected. If the clause is too narrow in its terms, it will not cover the obligation or liability it seeks to exclude or restrict. For example, an exclusion of liability for consequential loss or damage will not cover direct losses.*
- (2) *A clause may be drafted in such a way that its application might create an absurdity or defeat the main purpose of the contract. For example, a deviation clause in a bill of lading may be so wide that it could be applied in a way inconsistent with the main purpose of the contract voyage. The courts will try to give effect to the contract and clauses inconsistent with the main purpose of contract will be ineffective.*
- (3) *Construction contra proferentem: according to this rule, an ambiguity in a document is construed against the party seeking to rely on the ambiguous clause. In addition, when a party seeks to rely on an exemption clause, it bears the burden of proving that a case falls within the exemption and any ambiguity will be resolved in favor of the other party.*
- (4) *There is no rule of law to prevent the exclusion or restriction of liability arising from deliberate acts or omissions if the parties so intend."*<sup>38</sup>

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<sup>38</sup> (1) *Chitty on Contracts*, 29th edn (2004), Vol 1, para 14-006; *BHP Petroleum Ltd and Others v British Steel plc and Dalmine SpA* [1999] 2 Lloyd's Rep 583, 597-600; in *Caledonia North Sea Ltd v London Bridge Engineering Ltd* [2000] UKHL 4; [2002] 1 Lloyd's Rep 572, Lord Hoffmann reserved, in the context of claims to be indemnified for compensation paid to victims at levels higher than those which would have been available through the Scottish courts, on the question of the distinction between 'direct' and 'indirect or consequential' losses; *Westerngeco Ltd v ATP Oil & Gas (UK) Ltd* [2006] EWHC 1164 (Comm).  
 (2) *Chitty on Contracts*, 29th edn (2004), Vol 1, para 14-007; *Leduc v Ward* (1888) 20 QBD 475.  
 (3) *Chitty on Contracts*, 29th edn (2004), Vol 1, para 14-009; *Westerngeco Ltd v ATP Oil & Gas (UK) Ltd* [2006] EWHC 1164 (Comm).  
 (4) *Chitty on Contracts*, 29th edn (2004), Vol 1, para 14-016; *Red Sea Tankers Ltd v Papachristidis* [1997] 2 Lloyd's Rep 547, 586.

#### 4.1.2 Third Party claims

Apart from the exposure of risks in relation of properties and personnel owned by each contracting party and the indirect or consequential losses, there is another point of exposure related to risks of claims arising from third parties. As third party should be understood those not directly involved in the particular agreement, but who can be affected by its operation. As already stated above, offshore operations are potentially hazardous and the development of oil field involves a series of contracting of goods and services.

The numbers of Contractors performing services in an oil field are multiple (in the North Sea, particularly, it is not unlikely that 25 to 50 Contractors would be working side by side on the same project) and most of them will be linked to the Operator through separate/individual contracts. As there will not be any contractual relationship between Contractors, they would therefore be considered as third parties towards each other.

Irrespective of all improvements and regulations in terms of health and security of offshore workers, the occurrences of personal injuries during an offshore operation are still considerably high. If all Contractors working next to each other are considered as "third party" Contractors, these parties will be exposed to liabilities for injury and loss they cause to each other.

The allocation of risks in relation to damages sustained by those third parties can be assumed by either the Operator or the Contractor. In light of the knock-for-knock regime, the allocation of liability in relation to third parties will differ in the sense that the party which caused the damages will normally be responsible and compensate for such damages. Such concept is similar to the traditional and statutory legal regimes, in other words it is a negligence-based liability.

However, it is not uncommon that the indemnity provisions would be drafted in a way that the party which was given the indemnities would also indemnify the other party against the

members of its group. Therefore, the definition of a party's group would include some third parties that would be affected in case of an accident.

In practical terms and as far as the definition of Contractor's group is concerned it would be desirable that such definition include: Contractors' employees, agents and subcontractors. In the case of a company the definition should include its employees, affiliates, co-ventures and other Contractors engaged by the company to provide services in the relevant area of operations. This approach is also referring to the expansion of the contracting party's definition.

In order to give effect to that expansion, it is advisable that each of the contracting parties celebrates the so called "back-to-back" arrangements with each of the persons and companies included in their respective definition. By back-to-back agreement it is understood a contractual arrangement where the terms and conditions of the main contract are passed onto the sub-contractor on back-to-back terms.

Another practice that used to be common in the offshore operation in the UK was the implementation by the Operators of mutual hold harmless schemes (for people, property and consequential loss) on an installation-by-installation or a project-by-project basis. Under these schemes, Contractors essentially agree to hold each other harmless for loss, damage, injury, etc, to their people and property, even if caused by the negligence and/or breach of duty of another Contractor.

As an evolution of such practice, the oil and gas industry in the UK have developed an industry wide mutual hold harmless agreement which has been successfully accepted by most of the Offshore Contractors in the UKCS and will be addressed in next the chapter of this dissertation.

## 4.2 Industry mutual hold harmless scheme

Despite all efforts to allocate the potential risks arising from an offshore activity through the evolvement of the knock-for-knock principle, the enlargement of the definition of a contracting party and the mutual hold harmless regime on a project-to-project basis, the allocation of third parties' liability was not ideal and remained a potential issue, causing lots of disputes between Offshore Contractors.

The traditional contractual regime between Contractors and Operators stipulated that each of the parties would be responsible for its own negligence towards a third party. Unless a particular contract states otherwise or unless a Contractor makes a specific arrangement with all potentially affected third parties any time they go offshore, potential liabilities towards such third parties would be unlimited.

The alternative solution developed by the oil and gas industry in the UK was the creation of the mutual hold harmless scheme between Offshore Contractors (the "IMHH scheme). Such scheme was a significant contribution of the UK oil and gas industry and clarified the allocation of third parties' liability in offshore operations.

In summary, by ways of a deed of adherence to the industry mutual hold harmless deed (IMHH Deed), each of its signatories<sup>39</sup> agreed to *"create between them a mutual hold harmless and cross-indemnity arrangement to apportion liability and responsibility between themselves and their respective Groups so that each Signatory is responsible for its own Property, Personnel and Consequential Loss and the Property, Personnel and Consequential Loss of each other member of its own Group. The Signatories acknowledge and agree that such apportionment of liability is common practice in the offshore oil and gas industry in the United Kingdom. Such apportionment of liability is made for good*

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<sup>39</sup> By signatories it should be understood the Offshore Contractors which have signed up to the IMHH Deed.

*commercial and insurance reasons, principally to ensure that each Signatory is able to insure and/or manage the risk to which it is exposed during Services.*<sup>40</sup>

Another feature that contributed to the enforcement of the IMHH Deed was the Contracts (Rights of Third Parties) Act 1999. Such Act made possible under the English Law the ability to pass the benefit of indemnities to third parties, hence contracting parties' respective "groups" (their affiliates and personnel).

In practical terms, the IMHH Deed was drafted to cover the absence of a contractual relationship between Contractors working offshore in the UK continental shelf, and allocates the potential liability resulting from their offshore activities. In the absence of the IMHH Deed, the statutory negligence regimes would apply.

However, other purposes can be attributed to the IMHH scheme, such as:

- clarifying the allocation of the key areas of risk;
- bringing financial benefits from reduced legal fees;
- being more effective in managing of key areas of risk;
- reducing time and confrontation when negotiating contractual responsibility and indemnity matters;
- leading to greater industry collaboration;
- potentially reducing insurance premiums;
- avoiding unnecessary overlap of insurances policies;
- and finally, being cost-effective and efficient means of improved risk management for small- and medium-sized enterprises.<sup>41</sup>

The method proposed by the IMHH Deed (with associated deeds of adherence) covers UKCS offshore operations and applies where no contractual relationship otherwise exists between the Parties. However, it should be noted that the scheme does not cover

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<sup>40</sup> IMHH Deed - whereas (B) and (C).

<sup>41</sup> See further – [www.imhh.com](http://www.imhh.com).



helicopters, certain vessels (emergency response, rescue vessels, heavy lift vessels and supply vessels) and genuine visitors.

According to data extracted from the IMHH Industry website<sup>42</sup> *“it is believed that the industry as whole will make a significant financial saving from an effective implementation of the IMHH Scheme. It is impossible to put precise figures on this saving but industry discussions have suggested that a saving in legal fees of £17MM per annum may be possible. In addition to this there are the internal costs of all the parties involved in claims and counter claims which must be significant. The benefit across the industry could exceed £20MM per annum. Whilst these figures are merely indicative, they do reinforce that the potential prize is worth pursuing.*

*There may also be benefit in reduced insurance premiums. The legal burden incurred by the oil and gas industry is also, to some extent, reflected in the insurance industry. Reduced claims and counter claims may lead to a reduced level of legal fees for insurers which would hopefully have a knock-on effect on insurance premiums. However, risks in the industry will not change: the IMHH Scheme is simply a method of allocating liability. The IMHH Scheme should reduce the need for “double insurance” but does not remove the need for insurance altogether.*

*In addition to the financial penalty on the industry, there is the hidden cost of regular confrontation within the industry in contractual negotiations on liability and indemnity matters. The IMHH Scheme will not remove the risks but will allow them to be managed more effectively.”*

The IMHH Deed is administered by LOGIC and has 221 signatory companies.

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<sup>42</sup> See [www.imhh.com](http://www.imhh.com)

### 4.3 The exclusion of gross negligence and willful misconduct.

Discussions on the interpretation of knock-for-knock clauses have been concerned with the exclusion of gross negligence from their indemnity regime. Such exclusion has received several criticisms, in particular, from insurance people<sup>43</sup>, as in such case liability would revert to being allocated under applicable law and consequently would increase the exposure to liabilities if a party acts with gross negligence.

The main problem with this approach is that some jurisdictions, in particular common law<sup>44</sup> ones, do not have a precise definition for gross negligence or willful misconduct. Moreover, the common law system traditionally does not recognize different degrees of negligence: there can only be either a breach of a duty of care which results to negligence or no negligence at all. Therefore, a clear definition of gross negligence and willful misconduct is fundamental for the effectiveness of these two concepts.

The term “negligence”, in its ordinary sense, is fairly understood in most of legal systems and avoids disputes around whom and what should be considered as negligent/negligence. In simple terms, negligence shall constitute a failure to comply with the standard of care reasonably expected from a person - failure to act with the expected degree of care, competence, and skills. Therefore, when a contract provides for the exclusion of gross negligence, the degree of negligence that raises the act/omission up to being a gross failure should be clearly identified.

Another issue with the exclusion of certain degrees of negligence from a knock-for-knock indemnity is to demonstrate that a gross negligence or willful misconduct actually took

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<sup>43</sup> See further – Presentation at Standard Offshore Forum – Jennings, Barbara and Frew, Vivian (first published in Lloyd’s List).

<sup>44</sup> The system of laws originated and developed in England and based on court decisions, on the doctrines implicit in those decisions, and on customs and usages rather than on codified written laws.

place. In that sense, the definition negotiated in the contract will be determinant and shall be carefully drafted.

When it comes to Romano German legal system<sup>45</sup>, the concepts of different degrees of negligence are more understandable and some definition can be found in their respective legislation.

#### 4.4 Drafting Effective Indemnities Provisions

Based on the lessons learned from the English law cases and the evolution of indemnities' provisions in standard contracts, it is possible nowadays to effectively prescribe some relevant advice in order to draft effective indemnities provisions.

##### 4.4.1 Basic structure of an indemnity provision

The basic structure of an indemnity provision shall contain:

**A Party (...) indemnifies (...) a Group (...) from and against Claims (...) for certain subject matters (...), relating to the Contract/Works, for certain categories of loss and damages (...) irrespective of negligence and/or breach of duty (statutory or otherwise) and subject to certain exceptions (...).**

##### **(a) Party**

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<sup>45</sup> The "Romano-Germany system" is found in all Latin America, Continental Europe, most of Asia and Africa. The system is based on codified rules which aim to provide the framework of the law and to provide the judge with the guidelines for decision.

In general terms, indemnities are mutual or reciprocal – that is to say that each party gives a similar indemnity to the other. It is also important to mention that an indemnity is not given by a Group, as a Group is not party to a contract and therefore, can not take on obligation under the contract. However, as already explained in this dissertation, the benefits of an indemnity provision can be expanded to other parties to the contract, and to that effect a definition for “Group” will be necessary.

### **(b) Indemnifies**

It can often be found in indemnities provisions that the indemnifying party not only indemnify but also be asked to be responsible for/ liable for/ release for/ save/defend/indemnify and hold harmless. From a legal perspective this extensive list is not really relevant. Nevertheless, some of this wording has a clear recognized meaning under English law and could be useful for a general understanding of each, as follows:

“to indemnify” means to reimburse costs and/or losses, expenses, liabilities, damages etc, that the other party has suffered as a result of specified events – it is a financial obligation.

“to release” – when a party releases the other party from legal liabilities, it is different to indemnification and would mean that such party would not be able to sue the other party.

“To hold harmless” – partially implies a meaning similar “to release” in terms each company agreeing not to sue the other for certain losses. However, the meaning may go further to include a proactive obligation to stop or prevent other people from bringing actions insofar as within the control of that party. There is an element of preventing a dispute arising as well as holding the other party harmless from a dispute that has already arisen.

“To defend” contains some element of overlap. The indemnifying party will prevent third parties (or members to their group) from causing harm to the indemnified party. This can

also mean that the indemnifying party will reimburse the indemnified party if such party was sued by someone of the indemnifying party's group.

Based on the above definition, it can be concluded that the necessary elements for drafting are "defend, indemnify and hold harmless". Other inclusions would not confer any additional protection to the indemnified party.

### **(c) Group**

The definition of Group of either, as the party who is given the indemnification or the beneficiary, shall be as wide as possible in order to include all the people, persons, subcontractors who might be affected by the operations under a specific contract. Special attention must be given to the wording in order to deal with directors and thought must be given to determining whether there are other categories of people who should be included such as secondees and visitors. Another important concern is to know whether the definition of personnel considers day-rate contractors.

### **(d) Claims**

The definition of claims is also relevant and would normally include: *all claims, liens, judgments, awards, remedies, debts, liabilities, damages, costs, losses, and expenses, (including legal expenses) or causes of action of whatever nature [including without limitation those made or enjoyed by dependants, heirs, claimants, executors, administrators, successors, survivors or assigns].*

### **(e) Categories of loss and damages**

The usual matters of an indemnity provision would normally cover: (i) *people (death, injury and illness)* and (ii) *property (owned, leased, hired or otherwise provided), against damaged, loss and recovery.*

With respect to the coverage for loss of and damages to property and people, it should be mentioned the usual deviation from the knock-for-knock indemnity regime in the construction contracts should be mentioned where the Contractors may take risk of loss and damages during the construction phase (project property<sup>46</sup>). However, such deviation would normally be mitigated by an insurance coverage. Other matters may be contemplated in an indemnity clause, such as: Third Parties claims, pollution risks, damages and losses to reservoir and catastrophic losses.

The indemnification against consequential losses will normally be assessed by a specific clause in the contract and very often will be preceded by the formula: “Notwithstanding anything to the contrary provided herein”. As a consequence of some English cases<sup>47</sup>, the definition of consequential losses will normally include: (i) Consequential or indirect loss under applicable law and (ii) loss and/or deferral of production, loss of product, loss of use, loss of revenue, profit or anticipated profit (if any), in each case whether direct or indirect to the extent that these are not included, and (iii) whether or not foreseeable at the effective date of the commencement of the contract.

However, the extensive list of consequential losses may not be necessary for common law jurisdictions, where general concept of consequential losses are well recognized, such as in Brazilian Law<sup>48</sup>.

It is also important to expressly mention the relationship of the clause to the contract, in other words, expressions such as: “arising out of the Contract”, “arising out of the Works/Services” or “connected with the Contract” are extremely important.

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<sup>46</sup> By project property should be understood as the scope of work. Also referred to as the “Contract Works”.

<sup>47</sup> See – *British Sugar plc-v-NEI Power Projects Limited, Deepak Fertilosers and Petrochemical Corporation-v-Davy Mckee (London) Limited and ICI Chemicals & Polymers Limited, BHP Petroleum Limited-v-British Steel plc, and Haddley-v-Baxendale*.

<sup>48</sup> See further – GONÇALVES, Carlos Roberto – Responsabilidade Civil - 94. Conceito e requisitos do dano – pages 529-532

**(f) Irrespective of negligence and/or breach of duty (statutory or otherwise)**

As previously discussed, in the context of the Orbit Valve case it is crucial that the indemnity clause expressly provide the wording “irrespective of negligence or breach of duty (statutory or otherwise)” to the effect of the exclusion of negligence.

**(g) Exceptions**

Some exceptions to the application of an indemnity clause can be specified and will depend on several issues such as: legal requirements under the governing law of the contract, common contracting practice by each of the parties to that particular contract, requirements for a specific type of contracts. Such exceptions shall be carefully reviewed on case-by-case basis. Several examples of such exemptions can be mentioned: (i) “exclusion in the event of gross negligence/willful misconduct”, (ii) “damages arising from negligence of the counter party” (e.g. third parties), (iii) “damages whether solely and directly caused by one of the parties”, or (iv) “except where relating to” or “to extend that (...)”, which will be determined specifically.

#### 4.4.2 Overall cap

Although the Operator will often take the liability for risks which Contractors would not be able to insure against (such as third parties infrastructure, damages to reservoir or pollution), this still leaves substantial areas of potential liability for Contractors (in particular the costs of remedying defective performance or contract/permanent works<sup>49</sup>).

In order to prevent unlimited liabilities, the parties to a contract can negotiate an overall cap of liabilities<sup>50</sup>. Furthermore, for those circumstances where the liability for third parties

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<sup>49</sup> See herein below - item 4.5.1 (a) Loss or damages to properties and personal injuries.

<sup>50</sup> Overall cap of liability can also be referred in contracts to as “absolute cap”, “total cap”, “global cap” or “limitation of liability”

has been left to the applicable law, a properly drafted global cap may limit the Contractor's exposure.

However, in order to give effect to such overall limitation to Contractor's liabilities it is important that the Operator also indemnify the Contractor against the liabilities resulting from the excess of such limitation. Otherwise, the Contractor will remain exposed to unlimited liabilities.

It is also important to mention that it is appropriate for the global cap not to cover those areas where the Contractor has been indemnified by the Operator against the Operator's own losses and it may also be appropriate to carve out indemnities in other areas. Nevertheless, it is not appropriate to carve out termination provisions as termination may well follow on from contract breach, and it is precisely in this situation that a Contractor needs to be protected against an unquantifiable, thus uninsurable loss.

#### 4.5 Liabilities and indemnities provisions in standards agreements

In order to give a practical view of the knock-for-knock principle and how to draft effective liability and indemnity provisions in offshore contracts, it will be presented some examples of provisions contained in standard agreements used in the UK (LOGIC), Norway (NF07) and Brazil (PNBV Contract). In general term the views and comments which will be made under this chapter will take into account the Contractor's risk perspective.

As it will be illustrated in this chapter the standard contracts used in the North Sea (LOGIC and N07) perfectly reflects the knock-for-knock principle, thus provides a reasonable allocation of liabilities. It will also be demonstrated as counter-example to the regimes developed in the North Sea, the liability provisions contained in the PNBV Contract.



By reviewing those clauses it will be an opportunity to evaluate some of the exposure to risks<sup>51</sup> that Offshore Contractors will have while performing offshore contracts in UK, Norway and Brazil.

#### 4.5.1 LOGIC - Standard Contract - Construction - Edition 2 (UK) – Liabilities and Indemnities Clause

## 22. INDEMNITIES

*22.1 The CONTRACTOR shall be responsible for and shall save, indemnify, defend and hold harmless the COMPANY GROUP from and against all claims, losses, damages, costs (including legal costs) expenses and liabilities in respect of:*

*(a) loss of or damage to property of the CONTRACTOR GROUP whether owned, hired, leased or otherwise provided by the CONTRACTOR GROUP arising from, relating to or in connection with the performance or non-performance of the CONTRACT; and*

*(b) personal injury including death or disease to any person employed by the CONTRACTOR GROUP arising from, relating to or in connection with the performance or non-performance of the CONTRACT; and*

*(c) subject to any other express provisions of the CONTRACT, personal injury including death or disease or loss of or damage to the property of any third party to the extent that any such injury, loss or damage is caused by the negligence or breach of duty (whether statutory or otherwise) of the CONTRACTOR GROUP. For the purposes of this Clause 22.1(c) "third party" shall mean any party which is not a member of the COMPANY GROUP or CONTRACTOR GROUP.*

*22.2 The COMPANY shall be responsible for and shall save, indemnify, defend and hold harmless the CONTRACTOR GROUP from and against all claims, losses, damages, costs (including legal costs) expenses and liabilities in respect of:*

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<sup>51</sup> Such type of risk analysis can also be referred as Risk Assessment and represents one of the forms to mitigate risks.

*(a) loss of or damage to property of the COMPANY GROUP whether (i) owned by the COMPANY GROUP, or (ii) leased or otherwise obtained under arrangements with financial institutions by the COMPANY GROUP which is located at the WORKSITE arising from, relating to or in connection with the performance or non-performance of the CONTRACT, but excluding the PERMANENT WORK; and*

*(b) personal injury including death or disease to any person employed by the COMPANY GROUP arising from, relating to or in connection with the performance or non-performance of the CONTRACT; and*

*(c) subject to any other express provisions of the CONTRACT, personal injury including death or disease or loss of or damage to the property of any third party to the extent that any such injury, loss or damage is caused by the negligence or breach of duty (whether statutory or otherwise) of the COMPANY GROUP. For the purposes of this Clause 22.2(c) "third party" shall mean any party which is not a member of the CONTRACTOR GROUP or COMPANY GROUP; and*

*(d) loss of or damage to such permanent third party oil and gas production facilities and pipelines and consequential losses arising there from, as specified in and defined in and in accordance with Appendix 1 to Section I – Form of Agreement where such loss or damage is arising from, relating to or in connection with the performance or non-performance of the CONTRACT. The provisions of this Clause 22.2(d) shall apply only to such specified permanent oil and gas production facilities and pipelines which are within a 500 metre radius of any working barge or vessel which is at the time directly engaged in the construction or installation of the PERMANENT WORK but not while such working barge or vessel is in transit to or from the area where the PERMANENT WORK is to be constructed or installed or when performing any other operations. The provisions of this Clause 22.2(d) shall apply notwithstanding the provisions of Clause 22.1(c).*

*22.3 Except as provided by Clause 22.1(a), Clause 22.1(b) and Clause 22.4, the COMPANY shall save, indemnify, defend and hold harmless the CONTRACTOR GROUP from and against any claim of whatsoever nature arising from pollution emanating from the reservoir or from the property of the COMPANY GROUP or from any third party property described in Clause 22.2 (d) arising from, relating to or in connection with the performance or non-performance of the CONTRACT.*

*22.4 Except as provided by Clause 22.2(a) and Clause 22.2(b), the CONTRACTOR shall save, indemnify, defend and hold harmless the COMPANY GROUP from and against any claim of whatsoever nature arising from pollution occurring on the premises of the CONTRACTOR GROUP or emanating from the property and equipment of the CONTRACTOR GROUP (including but not limited to marine vessels) arising from, relating to or in connection with the performance or non-performance of the CONTRACT.*

*22.5(a) Subject to Clause 22.5(b), the CONTRACTOR shall be responsible for the recovery or removal and when appropriate the marking or lighting of any wreck or debris arising from or relating to the performance of the WORK or the property, equipment, vessels or any part thereof provided by the CONTRACTOR GROUP in relation to the CONTRACT, when required by law, or governmental authority, or where such wreck or debris is interfering with COMPANY operations or is a hazard to fishing or navigation and shall, except as provided for in Clause 22.2 and Clause 22.3, save, indemnify, defend and hold harmless the COMPANY GROUP in respect of all claims, liabilities, costs (including legal costs), damages or expenses arising out of such wreck or debris, whether or not the negligence or breach of duty (whether statutory or otherwise) of the COMPANY GROUP caused or contributed to such wreck or debris.*

*22.5(b) Notwithstanding the provisions of Clause 22.1, where the COMPANY provides transportation for the property of the CONTRACTOR GROUP to the offshore WORKSITE, and the COMPANY elects to, or is required by law or governmental authority to recover or remove or mark or light any wreck or debris of such property, the COMPANY shall, except as hereinafter provided, save, indemnify, defend, and hold harmless the CONTRACTOR GROUP from and against any claim of whatever nature relating to the costs of such recovery, removal, marking or lighting. Provided, however, that the foregoing indemnity and hold harmless shall not apply to the extent that the recovery, removal, marking or lighting arises as a result of the negligence or breach of duty (whether statutory or otherwise) of the CONTRACTOR GROUP.*

*22.6 All exclusions and indemnities given under this Clause 22 (save for those under Clauses 22.1(c), 22.2(c) and 22.5(b)) and Clause 25 shall apply irrespective of cause and notwithstanding the negligence or breach of duty (whether statutory or otherwise) of the indemnified party or any other entity or party and shall apply irrespective of any claim in tort, under contract or otherwise at law.*

*22.7 If either party becomes aware of any incident likely to give rise to a claim under the above indemnities, it shall notify the other and both parties shall co-operate fully in investigating the incident.*

*22.8 Where applicable and if requested by CONTRACTOR in writing, the COMPANY shall make available to the CONTRACTOR details of its other contractors to be present at the WORKSITE.*

## **25. Consequential Losses**

*For the purpose of this Clause 25 the expression “Consequential Losses” shall mean:*

- (i) consequential or indirect loss under English Law, and*

(ii) *loss and/or deferral of production, loss of product, loss of use, loss of revenue, profit or anticipated profit (if any), in each case whether direct or indirect to the extent that these are not included in (i), and whether or not foreseeable at the EFFECTIVE DATE OF COMMENCEMENT OF THE CONTRACT.*

*Notwithstanding any provision to the contrary elsewhere in the CONTRACT and except to the extent of any agreed liquidated damages (including without limitation any predetermined termination fees) provided for in the CONTRACT, the COMPANY shall save, indemnify, defend and hold harmless the CONTRACTOR GROUP from the COMPANY GROUP'S own Consequential Loss and the CONTRACTOR shall save, indemnify, defend and hold harmless the COMPANY GROUP from the CONTRACTOR'S GROUP own Consequential Loss, arising from, relating to or in connection with the performance or non-performance of the CONTRACT.*

**(a) Loss or damages to properties and personnel injuries.**

The clauses 22.1 (a) (b) and 22.2 (a) (b) are a classic examples of cross indemnities based on the knock-for-knock principle. In such clauses, both Contractor and Company (normally the Operator) agree to indemnify each other in respect of loss and damages to property owned by each of the parties and for its own personnel.

It can also be noted that the lessons learned from Orbit Valve case are address by the wording of clause 22.6, as contains an express exclusion of negligence from the indemnity provision termed: *“irrespective of cause and notwithstanding the negligence or breach of duty (whether statutory or otherwise) of the indemnified party or any other entity or party and shall apply irrespective of any claim in tort, under contract or otherwise at law”*.

However, Clause 22.2(a) provides one exception to the indemnities given by the company which is in respect of loss and damages to the “Permanent Work”. According to the definition contained in the contract, as a Permanent Work shall be considered: *“property of the Company arising from the Work”*. Such exclusion is very common in offshore construction contracts and it will normally be mitigated by an overall cap of liabilities

agreed in the contract, as contained in Clause 36.1 of the Standard Contract - Construction - Edition 2<sup>52</sup>.

**(b) Loss or damages to properties and personnel injuries to Third Parties.**

With respect to loss and damages towards third parties, clauses 22.1 (c) and 22.2 (c) provides a negligence-based liability, as often provided by offshore contracts. In such case, each one of the parties, Contractor and company, will assume liability caused to third parties as a result of their own negligence.

From a Contractors' perspective, important for third parties' liability is the definition of "Companies Group". It is desirable to have as expanded as possible a definition in order to include all possible third parties which might be affected by the activities during the performance of the contract, such as its Co-ventures, Affiliates, personnel and other Contractors.<sup>53</sup>

Furthermore, the Logic standard form has an important re-allocation of third parties' liability from a Contractor's perspective which is not found any other standard form. In clause 22.2 (d) liabilities for "*loss or damages to permanent third party oil and gas production facilities and pipelines and consequential losses arising there from*" were assumed by the Company. This exclusion represents an optimum allocation of liability for Offshore Contractors, in particular for those obligations in the contract that requires offshore activities.

Furthermore, it should be mentioned the benefits available to all Offshore Contractors in the UK through adherence to the IMHH scheme. As been explained in this dissertation, such scheme represents a full cross indemnities by and between the Offshore Contractors in

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<sup>52</sup> See further - Annexes - Logic Contract – Clause 36.1(a) and (b).

<sup>53</sup> See further Annexes – Logic Contract – 1 Definitions "COMPANY GROUP"

respect to loss and damages to their own property and personnel. Once more, that is an optimum allocation of liability.

(c) **Consequential Losses**

Clause 25 above is another example of an effective cross indemnity provision for consequential losses under English Law. Given the lack of clear definition of consequential losses available under English Law, the parties who intend to avoid such exposure of liability is required to provide an extensive definition of what should be considered as a consequential loss.

Yet, such extensive list of consequential losses might not be necessary under other jurisdictions, especially within the Romano-Germanic system, therefore, it is important to take into account the opinion of a legal counsel from such jurisdiction.

4.5.2 NF 07– Liability clause

*PART VIII LIABILITY AND INSURANCES*

*Art. 29 LOSS OF OR DAMAGE TO THE CONTRACT OBJECT OR COMPANY  
PROVIDED ITEMS*

*29.1 If loss of or damage to the Contract Object occurs between the start of the Work until the time when the Delivery Protocol has been signed or should have been signed in accordance with Art. 19.1 and 19.2, Contractor shall carry out necessary measures to ensure that the Work is completed in accordance with the Contract. The same applies if any loss of or damage to Materials or Company Provided Items occurs while they are at Site under Contractor Group's safekeeping and control.*

*Contractor's obligation to carry out measures stated herein applies regardless of whether negligence in any form has been shown by Company Group.*

*29.2 The costs of carrying out such measures as are stated in Art. 29.1 shall be borne by Contractor unless the damage is caused by Company Group or the damage is due to war, nuclear damage or terror.*

*Contractor's liability for such costs for any one occurrence is, however, limited to the deductibles for insurer's own risk under Company's insurance policies set forth in Art. 31.1, and in any event limited to a maximum of NOK [1, 5 or 7 millions] [to be determined in accordance with the provisions in the Protocol art. 4], provided that:*

*a) the loss or damage is covered by insurance policies as mentioned, or*

*b) the loss or damage is not covered by the insurance policies mentioned above as a result of circumstances for which Company carries the risk.*

#### **Art. 30 EXCLUSION OF LIABILITY. INDEMNIFICATION**

*30.1 Contractor shall indemnify Company Group from and against any claim concerning:*

*a) personal injury to or loss of life of any employee of Contractor Group, and*

*b) loss of or damage to any property of Contractor Group, and arising out of or in connection with the Work or caused by the Contract Object in its lifetime. This applies regardless of any form of liability, whether strict or by negligence, in whatever form, on the part of Company Group.*

*Contractor shall, as far as practicable, ensure that other companies in Contractor Group waive their right to make any claim against Company Group when such claims are covered by Contractor's obligation to indemnify under the provisions of this Art. 30.1.*

*30.2 Company shall indemnify Contractor Group from and against any claim concerning:*

*a) personal injury to or loss of life of any employee of Company Group, and*

*b) loss of or damage to any property of Company Group, except as stated in Art. 29,*

*and arising out of or in connection with the Work or caused by the Contract Object in its lifetime. This applies regardless of any form of liability whether strict or by negligence, in whatever form, on the part of Contractor Group.*

*Company shall, as far as practicable, ensure that other companies in Company Group waive their right to make any claim against Contractor Group when such claims are covered by Company's obligation to indemnify under the provisions of this art. 30.2.*

*30.3 Until the issue of the Acceptance Certificate, Contractor shall indemnify Company Group from:*

*a) costs resulting from the requirements of public authorities in connection with the removal of wrecks, or pollution from vessels or other floating devices provided by Contractor Group for use in connection with the Work, and*

*b) claims arising out of loss or damage suffered by anyone other than Contractor Group and Company Group in connection with the Work or caused by the Contract Object, even if the loss or damage is the result of any form of liability, whether strict or by negligence in whatever form by Company Group.*

*Contractor's liability for loss or damage arising out of each accident shall be limited to NOK 5 million. This does not apply to Contractor's liability for loss or damage for each accident covered by insurances provided in accordance with Art. 31.2.a) and b), where*



*Contractor's liability extends to the sum recovered under the insurance for the loss or damage.*

*Company shall indemnify Contractor Group from and against claims mentioned in the first paragraph above, to the extent that they exceed the limitations of liability mentioned above, regardless of any form of liability, whether strict or by negligence, in whatever form, on the part of Contractor Group.*

*After issue of the Acceptance Certificate, Company shall indemnify Contractor Group from and against any claims of the kind mentioned in the first paragraph above, regardless of any form of liability, whether strict or by negligence, in whatever form, on the part of Contractor Group.*

*30.4 Contractor shall indemnify Company Group from claims resulting from infringement of patent or other industrial property rights in connection with the Work, or Company's use of the Contract Object. Nevertheless, this does not apply where such an infringement results from the use of Drawings, Specifications, Company Provided Items or process licences nominated by Company from Third Parties.*

*Contractor's liability shall be limited to infringements in the country where the Contract Object, in accordance with the Contract, is to be used, and in the countries in which the Site(s) are located.*

*30.5 A party shall promptly notify the other party if it receives a claim that the other party is obliged to indemnify. Whenever possible, the other party shall take over treatment of the claim, provided always that Company shall handle all claims which may result in liability under Art. 30.3, third and fourth paragraph.*

*The parties shall give each other information and other assistance needed for handling the claim. Neither party shall, without the consent of the other party, approve of a claim which shall be indemnified, in whole or in part, by the other party.*

***PART IX LIMITATION AND EXCLUSION OF LIABILITY Art. 32 LIMITATION AND EXCLUSION OF LIABILITY***

*32.1 Company shall indemnify Contractor Group from Company Group's own indirect losses, and Contractor shall indemnify Company Group from Contractor Group's own indirect losses. This applies regardless of any liability, whether strict or by negligence, in whatever form, on the part of either group and - except as stated in Art. 17.3 and 24.2 - regardless of any other provisions of the Contract.*

*Indirect losses according to this provision include but are not limited to loss of earnings, loss of profit, loss due to pollution and loss of production.*

*32.2 Contractor's total liability for breach of contract, including liability in accordance with Art. 24, 25 and 26, and regardless of whether the Contract is terminated or not, shall be limited to 25% of the Contract Price.*

**(a) Loss or damages to properties and personnel injuries.**

In general terms the NF 07 reflects the knock-for-knock principles and also provides alternative solutions to allocate Contractor's liabilities.

The cross indemnities in respect to loss or damages to properties and personal injuries are described in clauses 30.1 (a) (b) and 30.2 (a) (b). Similarly to the examples available in the Logic Contract, each of parties agrees to sustain their respective losses to their properties and personnel and indemnify each other in respect of such losses.

Once more<sup>54</sup> the exemption will lie on the contracts works (defined in the NF07 as “Contract Object”), which is a common characteristics of construction contracts. However, clause 29.2 provides a limitation for such liability to the deductibles for insurer’s own risk under the Company’s insurance policies. This is a very good example of an alternative solution for allocation of liability.

**(b) Loss or damages to properties and personnel injuries to Third Parties.**

Here is another example of negligence-based liability for loss and damages towards third parties. Therefore, the parties will be responsibility for the loss and damages caused to third parties due to its own negligence.

Given the absence of a mutual hold harmless scheme in Norway, the definitions of the company and Contractor’s Group and the overall cap of liability will play an important role in allocating and mitigating such risk.

With respect to the definitions of Company’s Group, the NF07 includes Company’s Contractors as much as they are involved in the particular project covered by the Contract. As already explained, this expansion of company’s definition is an acceptable way of allocation for third parties liabilities. However, it would still remain some potential exposure to other third parties which are not directly involved in the project, but nevertheless would be affected.

Based on the above, it will be extreme relevant for the Contractor to negotiate an absolute limitation such liability. Clause 30.3 provides a limitation of liability to NOK 5 million for each accident. In addition, company provides an indemnity to Contractor in case such liability exceeds the limited amount per accident. Those provisions provides for an acceptable solution of allocation of such liabilities.

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<sup>54</sup> See comments herein above - (e) Categories of loss and damages.

(c) **Indirect Losses and Global Cap**

By indirect losses it could be understood those issues concerned to consequential losses and which were subject to several consideration in this dissertation. The definition of indirect losses includes loss of earnings, loss of profits, loss due to pollution and loss of production. It should be mention that such definition is more expanded comparing to the LOGIC Contract as it also includes loss due to pollution.

Clause 32.1 is an example of cross indemnity in respect to indirect losses suffered by each of the parties resulting from the performance of the contract. This indemnity is consistent with the principles of reasonable allocation of liabilities in an offshore contract. Therefore, each party shall indemnify the other party from its own indirect losses.

With respect to the global limitation of Contractor's liability provided in clause 32, that should represent an overall limitation of Contractors liability where the contract does not provide either an indemnity or a specific limitation. Instead of expressly excluding such provisions (indemnities or limitation provisions) the clause provide that the over all limitation shall affect liabilities for breach of contract.

The limitation is based on a percentage of the contract price and it represents a fair and reasonable limitation in respect breach of contract by Contractor. The traditional remedies available at law would be enough to compensate the company from its losses as a consequence of a breach of contract, however, that would represent a huge and unlimited exposure to liability to contract. Therefore, the limitation provided by the NF07 is adequate and acceptable.

#### 4.5.3 PNBV Contract – Liability clause

In this section it will be present the liability clause of the PNBV Contract for construction of semi-submersible Unit. PNBV<sup>55</sup> is the contractual vehicle used by Petrobras when contracting with companies out side of Brazil.

The governing law of the contract is the English Law and which effects have already been considered under this dissertation.

*22.1 Contractor Indemnity. Subject to the other provisions of this Agreement, **Contractor**, on behalf of itself, its Affiliates, successors, assigns, officers, directors, employees, and agents, **agrees to indemnify, defend, and hold harmless [PNBV], [PNBV] Project Manager, and their respective Affiliates, subsidiaries, successors, assigns, officers, directors, employees, and agents, from and against any and all liabilities, losses, expenses, and claims for personal injury or property damage that arise from or out of Contractor's negligent acts or omissions in the performance of the Work.** Contractor Parent Company will guarantee the full and faithful performance of all obligations of Contractor under this Agreement in the form attached as Exhibit XXV hereto. This guarantee is unconditional and irrevocable.*

*22.2 [PNBV] Indemnity. Subject to the other provisions of this Agreement, [PNBV], on behalf of itself, its Affiliates, successors, assigns, officers, directors, employees, and agents, agrees to indemnify, defend, and hold harmless Contractor, Contractor Project Manager, and their respective Affiliates, subsidiaries, successors, assigns, officers, directors, employees, and agents, from and against any and all liabilities, losses, expenses, and claims for personal injury or property damage that arise from or out of [PNBV's] negligent acts or omissions under this Agreement.*

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<sup>55</sup> Petrobras Netherlands B.V (PNBV), a company incorporated under the laws of Holand and a full subsidiary of Petrobras.

*[22.6 Limitation of Liability. The aggregate amount of Contractor's liability to [PNBV] for Liquidated Damages for Delay shall not exceed xx% (xxxx percent) of the Contract Price, and any such liabilities shall be limited to direct damages suffered by [PNBV] or any of its subsidiaries or Affiliates as an end user of the Facility. However, such limitation of liability shall not apply to any damages resulting from Contractor's gross negligence, willful misconduct, or willful refusal to perform the Work. The aggregate amount of Contractor's liability to [PNBV] for damages suffered by [PNBV] as a result of Contractor's violation of Environmental Laws and indemnification obligations of Contractor hereunder with respect to damages or injuries sustained by third parties are not subject to any limitation. This Section 22.6 shall not be construed to limit Contractor's other obligations or liabilities arising under or in connection with this Agreement. This Section 22.6 expressly survives the termination of this Agreement.*

***Consequential Damages.** Notwithstanding any other provision of this Agreement to the contrary but except for the provisions of Section 20.5, in no event shall [PNBV] or Contractor be liable to each other for any indirect, special, incidental or consequential loss or damage (other than such damages as may be included as a component of liquidated damages hereunder) including, but not limited to, loss of profits or revenue, loss of opportunity or use incurred by either Party to the other, or like items of loss or damage; and each Party hereby releases the other Party therefrom.*

**(a) Loss or damages to properties and personnel injuries.**

Clauses 22.1 and 22.2 are examples of liability provisions based on the negligence of the parties to the contract. It constitutes the classic position at law and can not be construed as an indemnity according to the knock-for-knock principle.

Central to this conclusion is the wording “any and all liabilities, losses, expenses, and claims for personal injury and property damages that arise from or out of [Contractor's]”

negligent acts or omissions in the performance of the Work.” In other words, each of the parties will be responsible for any claims resulting from its own negligence.

When it comes to Contractor’s liability, clause 22.1 goes even further as it requests a guarantee for the performance of the Contract in the form of a Parent Company Guarantee<sup>56</sup> from the Contractor’s parent company, worded as follows: “*will guarantee the full and faithful performance of all obligations of Contractors under this Agreement.*”

Although clause 22.2 provides the same exposure to liability (except guarantee obligation) for the Operator, such liability regime is proving to establish a disproportionate balance between Contractor and Operator.

As previously explained<sup>57</sup>, it is an industry common practice in the North Sea that each company (including Contractors) will assume liabilities related to their own people and property. Such concept was a necessary development of the activities in the oil and gas industry and many benefits have arisen from the mutual hold harmless (or knock-for-knock) regime.

From a Contractor’s perspective, the critical aspect of a negligence-based liability for damages to Operator’s property and personnel is the financial capacity of a Contractor to assume those liabilities. Most frequently, the financial capacity of a Contractor to assume those types of liability is inferior by far to the capacity of the Operator on the other hand. In some cases, insuring is not even possible or will be a duplication of insurance policies for the same events.

Another relevant aspect of these two clauses is that both are “*Subject to the other provisions of this Agreement*”. In that case, all other provisions of the contract should be

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<sup>56</sup> Parent Company Guarantee is a promise to take responsibility for another company's financial obligation if that company cannot meet its obligation. The entity assuming this responsibility is called the *guarantor*.

<sup>57</sup> See hereinabove Chapter 4 – Allocation of Risk.

counter-reviewed against these provisions, in particular clauses providing overall cap of liabilities.

**(b) Loss or damages to properties and personnel injuries to Third Parties.**

With respect to third party's liability, clause 22.6 provides a clear wording that "*with respect to damages or injuries sustained by third parties are not subject to any limitation*". Therefore, the liability that a Contractor may assume towards third parties is unlimited.

Such exposure represents a massive area of potential liabilities and the only form of mitigation that will be available to Contractors is an insurance policy. However, and without any doubts, the cost of such insurance will affect the Contractor's proposal and inevitably be passed over to the Operator in the contract price.

As mentioned above, the Operator will most probably secure said same risk under their own policy, which will only cause duplication of insurance policies for the same events, thus proving not cost effective.

**(c) Limitation of liability and Consequential Losses**

As explained in this dissertation, where the contract left the allocation of certain liabilities to traditional negligence available at law, the limitation of liability provisions will play a significant role in the contract. Clause 22.6 of the PNBV contract provides some relevant limitations to liabilities; however, the wording used in the clause is not as clear as it should be.

The first topic to be mentioned is the limitation for the Delay in the form of liquidated damages. Although the contract does not provide a definition for the term "Delay", the following could be considered as a definition: the delay to deliver the contract works. Such



limitation represents an important allocation of Contractor's liability, considering that the contract provides that "time is of the essence"<sup>58</sup>.

The issue of liquidated damages was not previously discussed in this dissertation as it is not one of risks normally allocated or mitigated through knock-for-knock regime. However, given inclusion in the overall limitation of liabilities contained in the PNBV Contract, a brief consideration will be given.

The main reason for pre-establishing the amount of damages in a contract is to release the party who has suffered the damages from the burden to have to prove such damages. In other words, the parties agree that, for certain events (such as delays), a fixed amount shall be paid by the party that caused the event and, such compensation shall be effective irrespective of the actual damages (if any).

Therefore, when clause 22.6 provides that "*any such limitation shall be limited to direct damages suffered by PNBV or any of its subsidiaries or Affiliates as an end user of the Facility*" it affects the whole point of having a liquidated damages provision in a contract.

In summary, contrarily to the main purpose of a liquidated damages provision, in the event of delay caused by Contractor, PNBV will have to prove that: 1) there were damages as a consequence of the delay, and ii) the damages were direct. Such an approach is actually another limitation to the Contractor's liability for delay.

Another critical issue with clause 22.6 is the exceptions of *gross negligence*, *willful misconduct* and *willful refusal to perform the Work*, as those terms are not defined in the contract. As already explained in this dissertation, the problem arises from the fact that those terms have no defined meaning under English Law, therefore, a contractual definition is crucial for the application of the concept. That is because, even though the role of

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<sup>58</sup> Using the term "time is of the essence" makes the timing in the contract a condition and missing deadlines therefore a breach entitling termination.

English courts of giving effect to the intention of the parties in a contract, the English courts do not make a distinction between negligence and gross negligence. Unless the contract explicitly states so the case will be reviewed on the bases of ordinary negligence.

With respect to the exclusion of consequential losses, once more the wording needs to be improved in order to guarantee a better effectiveness under English law. As been exemplified by the English Law cases herein discussed, such wording as: “*defend, indemnify and hold harmless*”, “*irrespective of negligence or breach of duty (statutory or otherwise)*” or “*arising from the performance of this Agreement*” should be included in any indemnity provision.

Although the provision of the PNBV Contract has never been challenged by the time this dissertation is written, based on the previous English law cases it can be concluded that those provisions might not be construed as limitation of liabilities for consequential losses. Therefore, the effects of the traditional negligence available at law would be considered by the courts.

## **CHAPTER 5 CONCLUSION**

The knock-for-knock principle is the one of the central legal pieces supporting the offshore contracts. The potential hazards involved in the offshore activities are multiple; therefore the allocation of liability provided by the knock-for-knock principle is a reasonable solution in that context. Moreover, it has a positive impact in terms of timing consuming with negotiation and it is insurance cost effective.

However, the correct application of the principle requires a certain maturity of the local industry. A good examples of this maturity is found in the standard agreements developed in North Sea are and they represent a great source of examples on how such principles should be reflected in the contracts. The contribution that comes from the North Sea can also be referred in the English court cases and the evolvement of a mutual hold harmless scheme between Offshore Contractors in the UK.

From a Contractor's perspective the exposure to liabilities for personnel injuries and/or loss or damages to offshore facilities, either belonging to Operators or other Contractors, is massive and simply not compatible with their normal risk of business. The consequences of such liability to Contractor can be beyond their financial capacity and sometime not even mitigated by insurance.

Without the knock-for-knock principle, it would be a disproportion between the obligations and liabilities assumed by and between the Operator and the Contractor. This has special significance in a development phase of an oil field, where several Contractors would be performing different services at the same site. Considering the particular context of the offshore industry, the knock-for-knock principle is a reflection of the proportionate risk and reward ratio in the offshore industry.

The allocation of liability provided by the knock-for-knock principle avoids the application of ordinary negligence provided at law and creates a contractual regime where each party will be responsible for their own losses. In practical terms it's an agreement of non-recourse against the other party even if the damages were caused by such party.

In the reviews presented in this dissertation it made clear that such concept of risk allocation is fully understood and implemented in the North Sea, opposed to the currently situation in Brazil. Part of this discrepancy can be attributed to the maturity of the oil and gas industry in North Sea, where licensing rounds back to the year of 1964.

In summary, it can be concluded that the exposure to liabilities that an Offshore Contractor assumes in the North Sea is limited to the performance of their scope of work in the contract. Therefore, all those issues related to (i) *loss and damages to property owned by each contracting parties*, (ii) *personal injuries, death or illness of personnel*, (iii) *indirect or consequential losses* and (iv) *third party claims arising out of personnel injuries, illness or death, or property loss or damages suffered by third parties*, are reasonably allocated on a knock-for-knock basis.

Another factor that contributed to the development of such principle in the North Sea can be attributed to the challenging of such principle toward the English courts. As reviewed in this dissertation, the Piper Alpha cases were a confirmation that the indemnities provisions are enforceable under English law.

During the period of researching for this dissertation it was concluded that the oil and gas industry in Brazil has not yet developed standard form of offshore contract as it is seen in

the North Sea. The offshore contracts currently used in Brazil are drafted by Petrobras and made part of their calls for tenders<sup>59</sup>.

The draft made available for the present analysis was relevant as a counter example of the knock-for-knock principle. In brief, the exposure to liabilities assumed by an Offshore Contractor in Brazil is based on negligence. That could be construed as an opposite solution given by the knock-for-knock principle.

In summary, it can be concluded that the standard forms of agreements are of great assistance for the oil and gas industry. The examples available in the North Sea reflect the advanced discussions around the knock-for-knock principle and could be of assistance to new markets, such as Brazil for the incorporation of such practices in their home states.

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<sup>59</sup> A “call for tender” is term used for the procurement for purchase of goods and services.

## **ABBREVIATIONS AND DEFINITIONS**

- BERR: Department for Business, Enterprise and Regulatory Reform.
- Contractor (or Offshore Contractor): term referred to a service provider company in the oil and gas industry.
- EPC: Engineering, Procurement and Constructions.
- EPIC: Engineering, Procurement, Installation and Construction.
- FDP: Filed Development Plan.
- Licensee: holder a licence.
- LOGIC: Leading Oil and Gas Industry Competiveness.
- NF07: Norwegian Fabrication Form (2007).
- Offshore Contract: same as Contractor.
- Operator: term used to refer to an oil company (holder of an oil and gas licence) and which retain the services of a Contractors.
- PNBV: Petrobras Netherland BV.
- UK: United Kingdom.
- UKCS: United Kingdom Continental Shelf.

## **LIST OF SOURCES**

### **LEGISLATION/REGULATIONS**

#### **Brazil**

- Petroleum Law No. 9478, 06<sup>th</sup> August 1997 (Brazil),
- Decree No. 2455, 14th January 1998 (Brazil);

#### **UK**

- Petroleum Act 1998 (UK);
- Contracts (Rights of Third Parties) Act 1999
- Continental Shelf Act 1964.
- Guidance notes on procedures for regulating offshore oil and gas field developments, issued by the BERR.

#### **Norway**

- Petroleum Act (Norway); Act 29 November 1996 No. 72 relating to petroleum activities. Last amended by Act 14 December 2001 No 98, 28 June 2002 No 61, 20 December 2002 No 88, 27 June 2003 No 68, 7 January 2005 No 2, 30 June 2006 No 60 and 26 January 2007 No3.

## **JUDGMENT/DECISIONS**

- Caledonia North Sea Ltd v London Bridge Engineering Ltd [2002]  
Caledonia Ltd v Orbit Valve Co Europe Plc [1995] 1 All ER 174 Court of Appeal;
- Mannai Investment Co Ltd v Eagle Star Assurance Co. Ltd;
- Investors Compensation Ltd v West Bromwich Building Society;
- Bank of Credit and Commerce International SA v Ali;
- British Sugar plc-v-NEI Power Projects Limited;
- Deepak Fertilosers and Petrochemical Corporation-v-Davy Mckee (London) Limited;
- ICI Chemicals & Polymers Limited, BHP Petroleum Limited-v-British Steel plc;
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**Last date visited for all: 15<sup>th</sup> August 2008**

- [www.org.berr.gov.br](http://www.org.berr.gov.br)
- [www.imhh.com](http://www.imhh.com)
- [www.logic-oil.com](http://www.logic-oil.com)
- [www.npd.no](http://www.npd.no)
- [www.abemi.org.br](http://www.abemi.org.br)
- [www.anp.gov.br](http://www.anp.gov.br)
- [www.petrobras.com.br](http://www.petrobras.com.br)
- [www.opsi.gov.uk](http://www.opsi.gov.uk)

## **LIST OF ANNEXES**

- Annex I - Logic contract
- Annex II - NF/07
- Annex III - PNBV Contract
- Annex IV - IMHH Deed

## **Annex I - Logic contract**

## **Annex II - NF/07**

## **Annex III - PNBV Contract**

## **Annex IV - IMHH Deed**